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2990

# Ways Out of Poverty

Diffusing Best Practices and Creating Capabilities—  
Perspectives on Policies for Poverty Reduction

*Michael Klein*

The World Bank  
Private Sector Advisory Services Department  
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## Abstract

Fundamentally, poverty reduction is about bringing growth processes to poor areas. Because poor areas can benefit from technical and organizational innovations made elsewhere in the world, it is possible today to create productive jobs faster and in greater quantity than ever before. The puzzle is what helps spread such “best practices.” Saving, investment, education, resources, and new technology are all needed—and fairly easy to obtain. What is hard to obtain are the institutions that allow these factors of production to be combined and translated into productive job creation. Firms are the key vehicles that spread best practices and productive jobs to areas where poor people live. Because we can never be sure which firm will be successful, it is necessary that

new firms can enter markets, that substandard firms are allowed to fail, and that good firms face few barriers to growth. This is the definition of competition, and competition is what selects good firms and thus drives the spread of best practice and productive jobs. Governments need to provide the framework in which capable firms can emerge. Yet, the right mix of state activity and how it best interacts with firms are not fully understood. Some selection mechanism, which allows for policy experiments and selects successful ones, is valuable for national, provincial, and local governments. Thus competition among jurisdictions and firms is an integral part of dynamic social systems that hold promise for creating wealth and ending poverty.

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# **WAYS OUT OF POVERTY**

## **DIFFUSING BEST PRACTICES AND CREATING CAPABILITIES**

**- PERSPECTIVES ON POLICIES FOR POVERTY REDUCTION -**

**Michael Klein\***

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\* Michael Klein is the director of the Private Sector Advisory Services Department (PSAS) at the World Bank.



# WAYS OUT OF POVERTY

## DIFFUSING BEST PRACTICES AND CREATING CAPABILITIES

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## I. EXECUTIVE SUMMARY

This paper provides perspectives on what can be done to overcome obstacles to development and poverty reduction. It argues that the key to poverty reduction is creating productive jobs where poor people live, which in statistics shows up as growth. Fundamentally, poverty reduction is not about redistributing the benefits of growth—it is about bringing growth processes to poor areas. Because poor areas can benefit from technical and organizational innovations made elsewhere in the world, it is possible today to create productive jobs faster and in greater quantity than ever before. The puzzle is what helps spread such “best practices.” The paper argues that saving, investment, education, resources, and new technology are all needed—and fairly easy to obtain. What is hard to obtain are the institutions that allow these factors of production to be combined and translated into productive job creation.

Some important institutions develop spontaneously, such as basic markets and small trade, which operate even in the most desperate corners of the world. But to create and sustain large numbers of productive jobs requires a complex web of institutions. The rise of modern firms and modern government, both non-market institutions that started in the mid-19<sup>th</sup> century, provides the critical institutional fabric allowing factors of production to be combined more productively. To be truly productive, firms need to play by certain rules and be able and willing to co-operate. They need to respect property rights and contracts so that they have incentives to invest and cooperate with buyers and suppliers. They also need to respect a variety of regulations that condition their property rights—to ensure that products and production processes fit society’s expectations about socially and environmentally sound practices. Under such rules, which require government enforcement, small and large firms emerge symbiotically, trading and contracting with each other.

Firms are the vehicles that spread best practices and productive jobs to areas where poor people live. But firms require certain routines to operate, and those routines may not always be effective or sustainable. Because we can never be sure which firm will be successful, it is necessary that new firms can enter markets, that substandard firms are allowed to fail, and that good firms face few barriers to growth. This is the definition of competition, and competition is what selects good firms and thus drives the spread of best practice and productive jobs.

The institutional fabric of societies consisting of firms, government and other types of organizations needs to combine competition and cooperation under agreed rules—a tricky task full of unavoidable tensions. Because the spread of best practices and more productive jobs upsets old patterns of production, it typically disrupts the lives of some people while improving those of others and in the end raises living standards broadly. Most if not all governments try to help the process along not just by establishing the basics of property rights and contract security but also by providing special support to small farmers and businesses or to larger ones under industrial policies that provide some protection from competition and easier access to credit. Politically popular, such policies can be effective in overcoming interest group resistance to reform. But their contribution

to productivity improvements is limited, particularly where the basics of security of property rights and contracts—and the freedom to enter and fail—are not in place.

An alternative is broader social protection schemes such as social security systems. When sensibly designed, these allow change to occur, while providing a safety net to individuals. To fund such systems productive jobs are needed first. But a basic level of security can also support greater risk-taking and thus enhance the scope for experimentation and change that bring more productive jobs in the end. Indeed, productive societies have seen a dramatic rise in the share of government activity in the economy, mostly due to the emergence of state-sponsored social protection. At the same time, countries around the world, notably Scandinavian ones, have withdrawn from interfering with the productive activity of firms that underpins wealth creation.

The right mix of state activity and how it best interacts with firms are not fully understood. Partial reforms can work. But they can also fail. Some selection mechanism, which allows for experiments and selects successful ones, is also valuable for national, provincial, and local governments. This competition among jurisdictions and firms is an integral part of dynamic social systems that hold promise for creating wealth and ending poverty.



## II. HOPE AND ANGER

*“First, I would like to have work of any kind.”  
- An 18-year old man, Ecuador*

**The challenge.** The quotation is from “Voices of the Poor,” a World Bank survey capturing the perspectives of poor people around the world.<sup>1</sup> Poor people know what they need to escape poverty. Finding a decent job or establishing a small business is the key.<sup>2</sup>

But not any job or any business will lead out of poverty. If it were simply a matter of creating jobs, having the state employ everyone would do the trick. This has been tried before in most parts of the world, notably in communist regimes. The key to poverty reduction is to create productive jobs and thus wealth, not just to compile odd jobs allowing people to scrape by. The basic sentiment comes from a man from Pakistan: “the rich have one permanent job; the poor are rich in many jobs.”<sup>3</sup> Needed especially are jobs and productivity improvements where poor people live, mostly in rural areas and the peripheries of cities.

**Hope.** The 20<sup>th</sup> century gave more hope that poverty could be eliminated than any other episode in human history. Average income per person, adjusted for inflation, increased at least five times over the century, despite unprecedented population growth from about 1.8 billion to more than 6 billion.<sup>4</sup> At century’s end, more people lived above the basic poverty line of \$1 dollar a day than even a decade before.<sup>5</sup> And when taking a definition of poverty broader than just income, human development in very poor countries, even in Mozambique, has advanced beyond that in Italy in the late 19<sup>th</sup> century.<sup>6</sup> For the first time in history it appears that increases in income may not lead to a Malthusian increase in population. Worldwide fertility rates peaked in the 1960s, and population growth has since started to slow.<sup>7</sup>

**Anger.** And yet, the absolute number of poor people has not fallen, even though their share in total population continues to decline. Advances are heavily concentrated in Asia, particularly China and India. In Africa, however, poverty rates increased over the last three decades. In Eastern Europe and the former Soviet Union they increased during the decade prior to the fall of communism and faster still thereafter. Nor have two decades of reform in Latin America prevented poverty rates from rising (figure 1). Whether all things considered global inequality has risen or declined during the last three decades of

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<sup>1</sup> Narayan et al., 2000.

<sup>2</sup> Detailed studies making use of household survey data confirm this. The single most important factors for escaping from poverty are changing labor earnings and changes in employment status. See, for example, Fields et al. (2000).

<sup>3</sup> Narayan et al., 2000.

<sup>4</sup> de long, 2000.

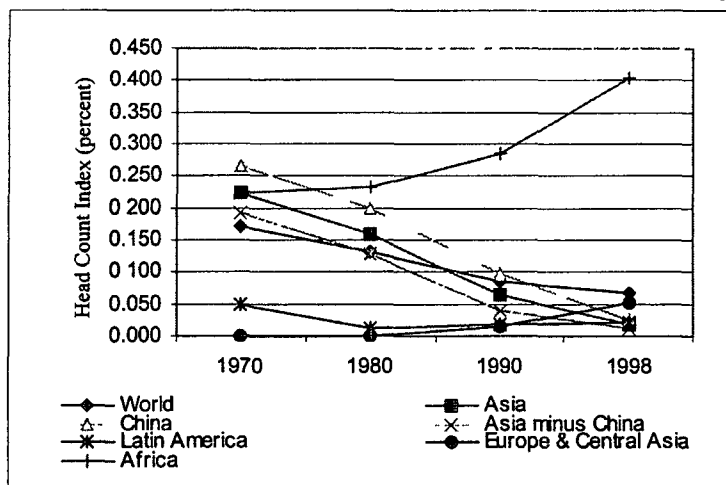
<sup>5</sup> Pfeffermann, 2000.

<sup>6</sup> Crafts, 2000.

<sup>7</sup> United Nations, 2001.

the 20<sup>th</sup> century remains hotly disputed.<sup>8</sup> In any case, roughly 1.2 billion people still live on less than \$1 a day, and 2.8 billion on less than \$2 a day.<sup>9</sup>

**Figure 1: Shares of world population living on less than \$1 a day**



Source: Sala-i-Martin (2002). Data for Europe & Central Asia are from World Bank (2000a).

Worldwide, the average income per person is about \$6,000 a year, no more than that for the United States in 1900, then the richest country in the world. The world has thus shown that it can produce enough for everyone to lead a better life. But many people have not benefited. And so, the century that has given rise to unprecedented hope has also given rise to anger that many people are left out. Precisely because we can now imagine a world without poverty, we can be angry about the slow progress. In the words of Nobel laureate Joseph Stiglitz: “The experience of the past fifty years has demonstrated that development is possible, but not inevitable.”<sup>10</sup>

<sup>8</sup> Milanovic, 1999; Ravallion, 2000; Sala-i-Martin, 2002.

<sup>9</sup> World Bank, 2002a.

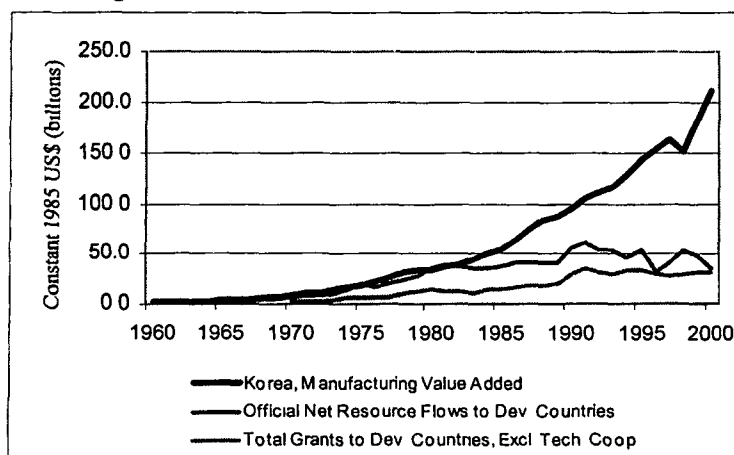
<sup>10</sup> Stiglitz, 1998a.

### III. BASIC WAYS TO PROMOTE PRO-POOR GROWTH

**Alternatives to market economies.** So what can be done for poor people to benefit from wealth creation? Today there are fewer alternative approaches to economic systems than at any time since Karl Marx wrote the Communist Manifesto in 1848. Some still hope for non-market solutions, but they are struggling, as exemplified in a recent speech by João Amaral, a reformist member of the Portuguese Communist Party: “We are not social democrats or market-friendly socialists. Communism means replacing capitalism with something better, even if we do not yet know exactly what that will be.”<sup>11</sup> Maybe at some future date a completely different economic system will emerge. For now we have to make some kind of system making use of markets.

**Redistribution of income.** The question becomes what pro-poor policies mean in market economies. Some focus on redistributing incomes. For example, a guaranteed basic income for all was recently proposed by the Basic Income European Network.<sup>12</sup> The massive redistribution required for such a plan on a global scale would require that economic growth is adequate to fund it. In addition, it requires willingness of rich countries to fund the plan. Yet, the official development aid of all nations amounts to less than \$0.15 for each person living on less than \$1 a day, and most of that has to be repaid. Compare that with the Republic of Korea, which took about 10 years to generate more income for its citizens from the manufacturing sector alone than all of the world’s development aid together (figure 2).

Figure 2: Growth achieves more than redistribution



Source: World Bank WDI Database.

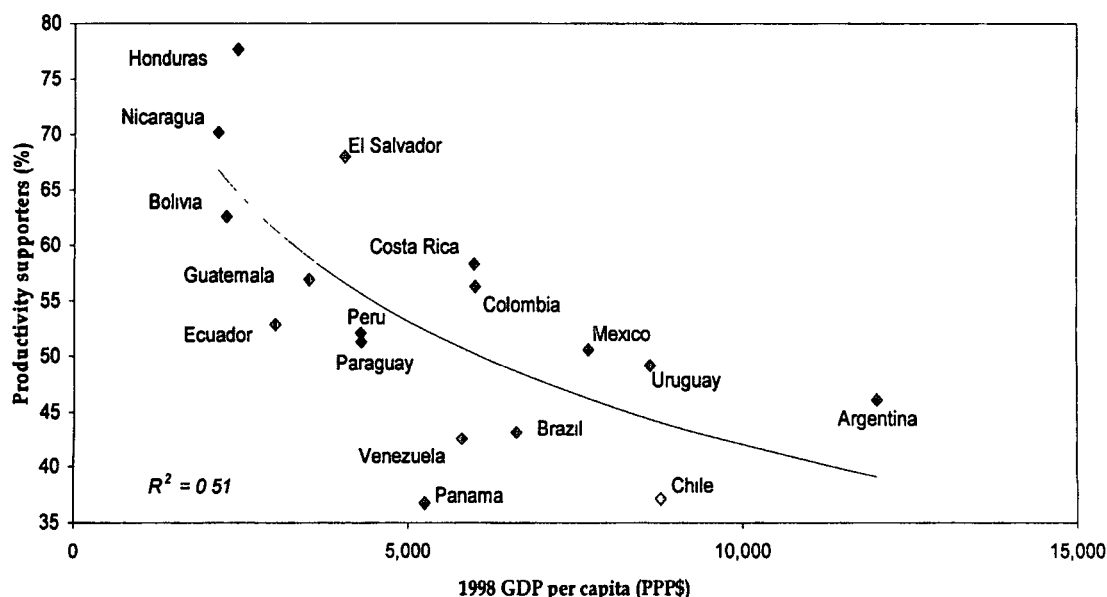
**Creating productive employment.** Even doubling the world’s official aid and transforming all loans into grants would not achieve sustained economic growth in countries and areas where poor people live. The hope for poor people lies in productivity

<sup>11</sup> Wise, 2002.

<sup>12</sup> Williams, 2002.

growth, not in redistribution. Opinion polls in Latin America show that the poorer people are, the more they place their hopes on productivity growth than on redistribution (figure 3).

**Figure 3: What do people think their country needs most to get ahead—more productivity or more redistribution?**



Note: The vertical axis represents the percentage of people in the opinion poll who chose productivity growth over redistribution.

Source: Graham, in Fields and Pfeffermann (2002).

Most debates about pro-poor growth today center on means to provide opportunity to poor people by improving their health and education,<sup>13</sup> by providing them access to credit,<sup>14</sup> by connecting them to the global market,<sup>15</sup> by helping to create risk insurance schemes, and by creating jobs through stimulating overall growth in poor countries and regions.<sup>16</sup> Required is deeper understanding of what such interventions can accomplish and how to implement them effectively. But the basics are clear. Growth processes need to spread to areas where poor people live or where they can migrate.

<sup>13</sup> World Bank, 2002b.

<sup>14</sup> Morduch, 1999; Robinson, 2001.

<sup>15</sup> See World Bank, 2002b for examples of how information and communications technology is being used around the world to connect producers in low-income or remote areas directly to buyers and to provide them with access to market and business-related information.

<sup>16</sup> Stern, 2001.

#### IV. DRIVERS OF GROWTH AND JOB CREATION

*“There is a tendency to see development as the accumulation of something necessary. For a while it was infrastructure...human capital.... It has been other things as well. There’s obviously truth in those paradigms, but in a deeper sense, societies that succeed in developing are societies where the fairly common individual pursuit of selfish objectives lead to benign social outcomes because of checks and balances in governments, because of enforced private property rights, because of incentives for creativity and entrepreneurship.”*

Lawrence Summers

##### A. Accumulation of capital and ideas

To understand pro-poor growth, one needs to understand growth. Clearly, growth requires the accumulation of various types of capital—financial, physical, natural, and human. Most important, the accumulated technical and organizational innovations of humankind can, in principle, enable poor countries to catch up fairly fast with richer ones. But simply making resources and innovations available does not lead to growth.<sup>17</sup>

**Finance.** Poor countries in Sub-Saharan Africa received capital transfers in the form of development aid averaging some 10 percent of GDP a year over the 1990s, a very high level of inflows relative to the size of the economies. But this did not translate into sustained growth. Instead, Africa became the region of the world with the highest incidence of capital flight.<sup>18</sup> Estimates reveal that almost 40 percent of private wealth is held outside the region.<sup>19</sup>

**Investment.** Nor do high investment rates translate automatically into high growth. Most dramatic here are the former communist countries, where investment rates of 30 or even 40 percent of GDP were among the highest in the world. But they imploded in a spectacular way. Hong Kong and Singapore had similar growth per person, but Hong Kong did it with significantly lower investment levels.<sup>20</sup> The United States still achieves strong growth with investment rates just below 20 percent of GDP.

**Natural resources.** Natural resources, fuels, and other agricultural and nonagricultural commodities remain critical for economies everywhere. But over the 20<sup>th</sup> century the price of non-fuel commodities fell by four-fifths in real terms, while per capita income grew five-fold (figure 4). Fuel prices have also declined slightly as they were buoyed by

<sup>17</sup> Easterly and Levine, 2001; Temple, 1999.

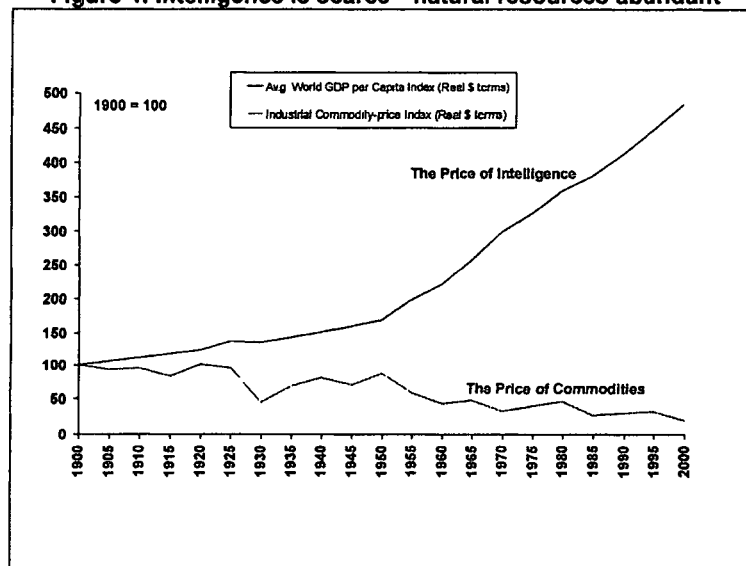
<sup>18</sup> World Bank, 2000b.

<sup>19</sup> Collier and Gunning, 1999.

<sup>20</sup> Young, 1992.

OPEC during the last 30 years. So, despite massive population growth, the relative scarcity of natural resources has shrunk. Nor is possession of resources the key to growth. Botswana (diamonds) and Chile (copper) have benefited from their resource endowments, but the possession of natural resources can also be a curse.<sup>21</sup> The “curse of oil” characterizes the fact that countries endowed with high priced, large volumes of oil are not growing much or are even shrinking. Look at Nigeria, Saudi Arabia, and Venezuela.

Figure 4: Intelligence is scarce—natural resources abundant



Source: *The Economist* (Commodity Price Index); World Bank WDI Database.

**Human capital.** Even investment in education does not easily translate into superior growth.<sup>22</sup> Educational progress in Africa was much faster relative to its starting point than in East Asia, but did not bring higher growth. Educational improvements overall in the developing world in fact coincided with declining growth rates during the last 40 years. Detailed household surveys also suggest that educational levels are not critical in explaining who escapes from poverty.

**Access to resources and capital.** None of this is to say that finance, investment, natural resources, or education do not matter. They do, but by themselves they are not enough. And on the positive side, it has become easier to move finance into good investment opportunities. Trade barriers have been lowered, so it has become easier to acquire capital goods that embody new technologies. And the education levels needed for income growth in poor countries do not appear to be too difficult to achieve.

<sup>21</sup> Gelb et al., 1988; Sachs and Warner, 2001.

<sup>22</sup> Pritchett, 1996.

**The diffusion of ideas and income growth.** Technical and organizational innovations have led to an unprecedented creation of wealth (box 1). Innovations have the nice feature that, unlike physical objects, they can be used over and over again, if they can be communicated.<sup>23</sup> It is this feature of ideas that makes it possible for poor countries today to raise incomes much faster than has ever before been feasible.

**Box 1: The speed of wealth creation**

Before the 18<sup>th</sup> century per capita income grew very slowly. When they grew, population growth risked offsetting any progress, just as T. Robert Malthus argued at the beginning of the industrial revolution. In the run-up to the industrial revolution per capita income started rising. However, it took some 350 years for incomes to double in pre-industrial Europe. During the industrial revolution, the richest country, Britain, initially (1780 – 1830) saw average individual incomes rise at a speed that would have required 175 years to double them. Thereafter growth picked up. Britain was able to double per capita incomes within a span of 65 years in the late 19<sup>th</sup> century. At the time no other country could rival this performance. However, by the second half of the 20<sup>th</sup> century, a whole range of countries, for example Botswana, Chile, China, Ireland, Japan, Korea and Thailand were able to grow for sustained periods at rates that doubled per capita income in about 10 to 15 years.

Source: Cameron (1991); Crafts (2000).

For the first time in human history it has become possible for large numbers of people to escape from poverty within a life span. Today people in poorer countries can make use of new technology, new learning, and better ways of doing things that were developed in more advanced economies. They can learn from organizational innovation in both firms and governments. Openness to learn from other countries—or within a country from centers of growth—is thus critical for rapid income growth and poverty reduction.<sup>24</sup>

The diffusion of ideas has also become easier. Many more ideas are recorded, and the means of communication have become faster, more efficient and more ubiquitous. Ideas might not move quite as easily as finance these days, but one can acquire new ideas embodied in imported machines, buy technology licenses, study at home or abroad, and use the Internet. And Korea shows that acquiring new technology and ideas from overseas is fairly cheap. It spent less than 1.5 percent of the increase in GDP over 1973–79 on the technology licenses that underpinned manufacturing growth.<sup>25</sup>

<sup>23</sup> Romer, 1993.

<sup>24</sup> Note that the static efficiency gains from trade liberalization cannot explain the main benefits from openness. Static gains from trade are typically one-off benefits in the order of 2 percent of GDP or maybe 4 to 6 percent of GDP in the presence of product differentiation or economies of scale. These are important but not nearly as important as the gains from learning that drive successful growth processes.

<sup>25</sup> See Olson, 1996. More generally, while innovators can earn a fair deal of money, they rarely receive the full rents from their innovation. For example, Thomas Alva Edison received but a fraction of the benefits that electric light created. Even patent protection, unless excessive, just affords the innovating firm on average with a normal rate of return on the cost of invention. Patent protection is meant to prevent that new ideas are simply made available for free so that inventors retain an incentive to spend time and money to innovate. But most of the benefits of successful inventions are passed to consumers in competitive markets.

## **B. Impediments and Traps**

**Types of impediments and traps.** If the provision of capital does not drive growth, if finance, capital goods and know-how are not very hard to obtain, why is it difficult for some countries to grow? One set of arguments has to do with a variety of “traps” or lasting impediments that prevent countries from growing rapidly. They may suffer from being small or landlocked or plagued by inclement climates.<sup>26</sup> They may suffer from ethnic strife or civil war.<sup>27</sup> They may have policy and institutional rigidities induced by vested interests.<sup>28</sup> They may suffer from cultural biases or a lack of trust, a critical part of social capital.<sup>29</sup>

**Escapees from traps and impediments.** Whatever the trap, some country has been able to escape from it. All countries that are developed today have over long periods of time emerged from “hopeless” situations. Who would have thought at the time of the thirty-years war (1618 to 1648) that Germany would ever be an economic powerhouse?

Today many countries have escaped from their trap fairly fast by historical standards.

- Adverse climate conditions can be overcome. Tropical Singapore is a rich country, and Malaysia and Thailand have also performed well as did Venezuela over most of the 20<sup>th</sup> century until the curse of oil set in during the late 1970s. At the other end of the climate spectrum Scandinavian countries boomed during the 20<sup>th</sup> century including isolated, inhospitable Iceland.<sup>30</sup>
- Remote location need not prevent development either. Landlocked, tiny Botswana has consistently been a star performer in recent decades. Landlocked Uganda emerged very rapidly from the days of civil war and dictatorship and experienced a strong growth episode in the 1990s. The tiny island of Mauritius became one of Africa’s best performing economies.
- Recovery is possible from civil strife. Civil war ended in El Salvador in 1992. Six years later per capita income had increased by 17 percent. Its human development index was up 8 percent, all without increasing the debt burden. Indeed, El Salvador became the third country in Latin America to receive an investment grade bond rating in 1998 – before Mexico.
- Countries that languish for many decades can turn around. Ireland, which suffered decades of emigration and economic stagnation, overtook the United Kingdom in per capita income in the 1990s, driven by productivity growth from foreign investment.
- Even deeply entrenched dysfunctional institutions may be overcome. Several former communist countries—constrained by a formidable set of growth

<sup>26</sup> Gallup et al., 1998.

<sup>27</sup> Collier, 2000; Collier and Gunning, 1999.

<sup>28</sup> Acemoglu and Robinson, 2000; Havrylyshyn and Odling-Smee, 2000; Hellman, 1998.

<sup>29</sup> Collier, 1998; Fukuyama, 2000.

<sup>30</sup> There was hardly a free-standing house in Iceland a hundred years ago and people lived half underground in grass-covered huts.



restraining institutions, policies, and vested interests—turned around within a decade, particularly China and Central Europe.

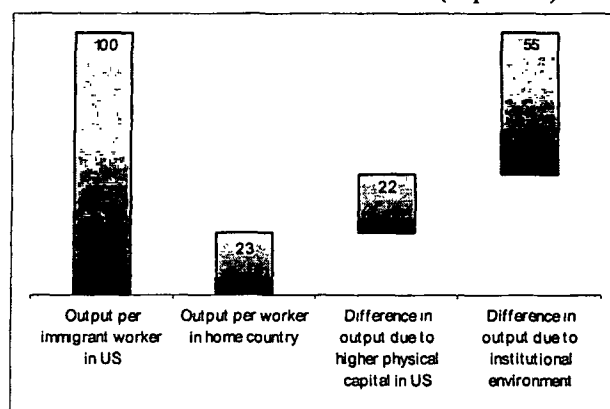
**Arrested development.** Precisely because many countries have become so much richer, we now see that some may run into “traps” at higher incomes. Argentina, once among the most advanced in the world, has stagnated relative to others since the 1930s. Stagnation could also befall Japan. The communist countries that initially grew in the early phases of industrialization are the most dramatic illustration of the phenomenon. We do not know how to predict such cases, but it seems clear that, after initial success, development may be arrested for some time.

Overall, while many countries have emerged from traps, many others have not or are getting trapped again. The upshot appears to be that there are indeed a variety of factors that make it hard for a country to develop, but they can in principle be overcome – often in fairly short time. What it takes to do so is the issue.

### C. The key to development: Capable institutions

**Countries.** One way to reduce poverty is to allow poor people to move to richer countries. Immigrants in the United States of America produce more than 4.5 times more there than in their country of origin. Their skill level is the same. They benefit from extra and more advanced physical capital in the United States. But that explains only about a third of the difference (figure 5). The main explanation is the capability of institutions—be they firms or governments—that allow individuals to perform at higher levels of productivity.

**Figure 5: Factor accumulation accounts for only a fraction of income differences (in percent)**

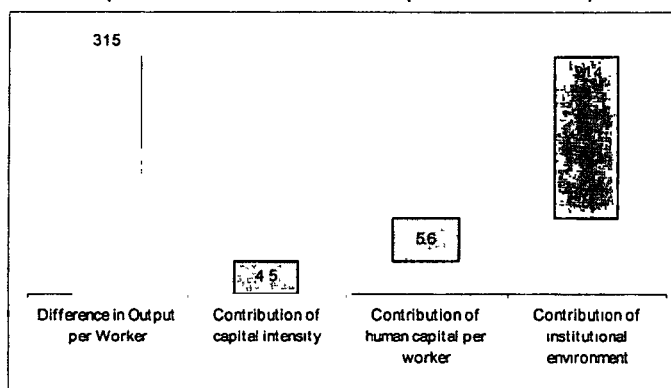


Source: Calculations based on Hendricks (2002).

Looking at output in 127 countries, Hall and Jones (1998) find that human and physical capital differences account for only a modest amount of the difference (figure 6). The

biggest factor remains hard to capture. It is not new that unexplained residuals in statistical studies of growth are large for particular countries.<sup>31</sup> But comparing productivity across countries shows the full extent of the elusive “unexplained residual.”

**Figure 6: The difference in output per worker is due to difference in institutional environment**  
(ratio of the 5 richest to the 5 poorest countries)



Source: Calculations are based on Hall and Jones (1999).

Various things have to come together to raise productivity and incomes. For example, the more open an economy is—and with it presumably the ability to learn—the more education becomes useful.<sup>32</sup> For another example, the higher the level of domestic education, the more productive foreign investment becomes.<sup>33</sup> All this points to the power of institutions that enhance the division of labor.

**Regions.** Productivity also differs among regions within countries. Consider the coastal and interior provinces in China, or the North East of Brazil compared with Sao Paolo. Even where labor is mobile and the free movement of goods, services, and capital reigns, significant productivity differences can persist. A study of Italy suggests that long-standing differences between the North and South of Italy reflect differences in trust among people based on long-standing patterns of behavior, what the author calls “social capital.”<sup>34</sup> In short, the environment people operate in makes a real difference to productivity.

**Cities and clusters.** Also critical, cities tend to be more productive than other parts of a country. More ideas are generated there, and incomes are higher. Why? Because cities allow for flexible labor markets and work arrangements, production and subcontracting methods, and easier flows of ideas (figure 7).<sup>35</sup>

<sup>31</sup> Denison, 1967; Solow, 1957.

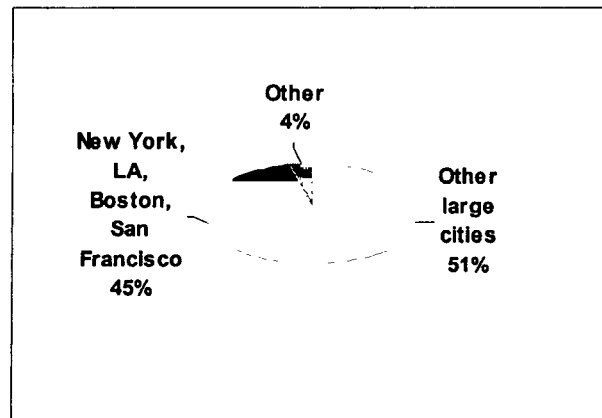
<sup>32</sup> Krueger, Alan B. and Mikael Lindahl, 2001; Lopez et al., 1998.

<sup>33</sup> Borenstein et al., 1994; World Bank, 2001a.

<sup>34</sup> Putnam, 1993.

<sup>35</sup> Glaeser, 1998; Jacobs, 1969.

**Figure 7: Location of new product innovation in the United States (percent)**



Source: Glaeser (1998).

Clusters of firms as in Silicon Valley (information and communication technology) and in Northern Italy (textiles and garments) provide benefits similar to those in cities.<sup>36</sup> As executives in Silicon Valley expressed it: "...People change jobs without changing carpools..." and "...the network in Silicon Valley transcends company loyalties. We treat people fairly and they are loyal to us, but there is an even higher level of loyalty – to their network..."<sup>37</sup> Cities are forms of clusters, the best known way to incubate small enterprises.

**Firms and the diffusion of best practice.** Then there are firms.<sup>38</sup> Large, multi-plant firms—which exhibit some features similar to those of clusters, such as flexible internal labor markets, loyalty to the larger firm, flexible internal contracting—are more productive than smaller ones. In many developing countries foreign firms are more productive than local ones are, suggesting a way to import some types of capability. Most important, firms spread best practices and thus wealth through channels that may cross national boundaries. They equally function within a particular country. De facto, studies of cross-border links between firms have attracted more attention. Hence, some of the following discussion has a flavor of international learning channels. However, the same or similar mechanisms are at work within countries.

**Productive, new entrants from other areas.** One way of improving firm-level performance is for more productive firms to move into new markets through new investments or through mergers or acquisitions. Across borders we call this foreign direct investment. Foreign firms and joint ventures with foreign firms typically exhibit higher productivity than local firms in developing countries.<sup>39</sup> Foreign firms employ mostly local workers and managers, training them on the job in new technical and organizational

<sup>36</sup> Porter, 1998.

<sup>37</sup> Saxenian, 1996.

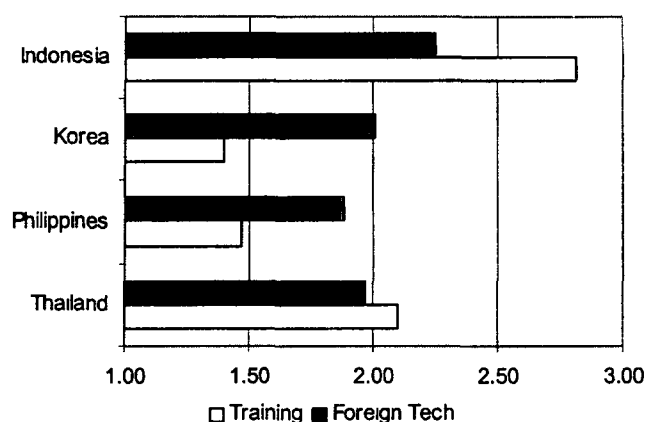
<sup>38</sup> Sutton, 2000.

<sup>39</sup> Barberis et al., 1996; Blomstrom and Sjöholm, 1998; Djankov and Murrell, 2002; Earle and Estrin, 1998; Havrylyshyn and McGettigan, 1999.

practices. The superior performance of direct foreign investors tends to provide them with greater market share in their sector. Over time, local competitors may be able to catch up as well, but initially they tend to lose market share.<sup>40</sup> Similar processes are at work within countries. Efficient companies from one part of a country move into other regions and improve productivity there.

**Learning by buyers and suppliers.** Subcontractors to foreign investors appear to be helped by their presence. Dealing with demanding foreign investors helps them upgrade their quality and reduce costs. In varying degrees foreign investors provide active support to their suppliers to improve performance.<sup>41</sup> Contracting also takes place across borders. Export opportunities provide the competent domestic firms with the option to expand their market, and firms can learn to upgrade their productivity, as studies of firms from East Asia and Mexico suggest (figure 8).<sup>42</sup> Demanding customers in high-quality markets are a key force driving performance improvements.

**Figure 8: Exporters spend more on training and acquiring foreign technology**  
(ratio of expenditure by exporters to domestic-oriented firms)



Source: Hallward-Driemeier (2001).

**Firms as incubators for new entrepreneurs.** Another important way for new and more productive firms to emerge is for people who learned in one firm to leave and set up their own firm. Take the garment industry in Bangladesh, where locals learned from a Korean company, Daewoo (box 2). They later set up their own businesses in Bangladesh, which in turn produced more small entrepreneurs. In a short time the garment industry became Bangladesh's leading export industry, accounting for almost 75 percent of the export earnings in 2001. In India the most efficient machine tool company was set up by employees from older, less efficient machine tool companies.

<sup>40</sup> Aitken and Harrison, 1999; Djankov and Murrell, 2002.

<sup>41</sup> Batra and Tan, 2000; Batra and Tan, 1995.

<sup>42</sup> Hallberg et al., 2000.

**Box 2: The role of policy reforms and diffusion of good practices in the growth of the Bangladesh garments industry**

The garment industry in Bangladesh grew from nothing in 1979 to about \$5 billion of exports per year—a little over three-quarters of the current annual export earnings in Bangladesh. This phenomenal growth is due to the diffusion of good practices, from foreign to one local enterprise and from the local enterprise to many others. It is also due to a number of policy and administrative improvements that opened up investment opportunities for local entrepreneurs.

It all started in 1979 with the collaboration between the Korean company, Daewoo, and the Bangladeshi enterprise, Desh Garments. Daewoo did not make any capital investment in Desh, but it signed a five-year contract to help Desh purchase machinery and fabric (some of it on credit from Daewoo), to set up the factory and market the garments. The contract also included training of Desh employees in Daewoo's plant in Korea and at Desh facilities in Bangladesh. About 130 Desh employees received very intensive training in technical production skills, management, and marketing at Daewoo in Korea. They returned to Bangladesh with technical production and marketing know-how plus an appreciation of the corporate culture required for success in export markets. Daewoo sent its own technicians to Desh to help set up the machines, oversee quality assurance in production, and train Desh workers who had not been to Korea.

Garment production began in 1980 with 450 machines and 500 workers. By June 1981, Desh already felt that it was ready to operate on its own and terminated its contract with Daewoo. In 1980 Desh produced 43,000 shirts at a value of \$56,000. By 1987 sales had risen to 2.3 million shirts worth \$5.3 million. The quality of Desh's garments had also improved significantly. The unit export price increased by 75% from \$1.30 to \$2.30. Between 1980 and 1987, Desh expanded from 450 machines to 750, and its workforce increased from 500 to 1,400. By 1987, Desh was handling its own export marketing and was buying all its raw material from sources other than Daewoo.

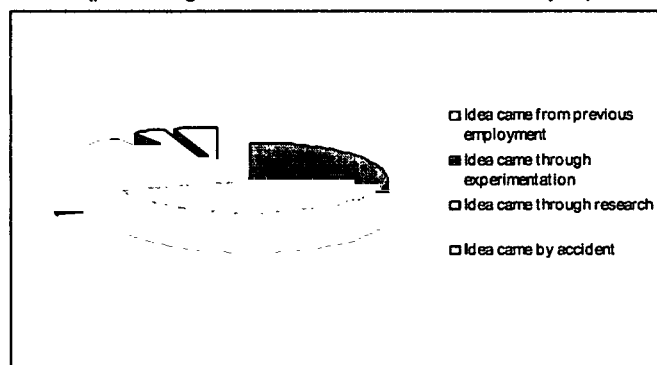
More interesting, of the initial batch of 130 employees who visited Korea in 1980, 115 left the company by mid-1981 to start their own garment-exporting businesses and began replicating Desh's success in other factories. By 1985 Bangladesh had 700 garment export manufacturing factories.

Source: Mahmood (2002).

Many successful small companies are founded by ex-employees of larger companies, where they learned their job. Often they learned about opportunities that their previous employer did not recognize or did not wish to exploit. The former employer might have been stuck in routines that were too hard to change or might have been reluctant to embark on new ventures that would undermine or cannibalize successful product lines.<sup>43</sup> The most detailed attempt at studying the phenomenon comes from the United States: more than 70 percent of new ventures were set up by employees who got their business idea when employed by another company (figure 9).

<sup>43</sup> Christensen, 1997.

**Figure 9: Origin of Innovation in the United States**  
(percentage of 1989 Inc. 500 founders surveyed)



Source: Bhidé (2000).

#### **D. Poverty reduction: The diffusion of best practice and the creation of capability**

*"...The engine (of development) is the advance of technology and the diffusion of technical capacities of people, firms and governments..."*

Robert Wade

*"...If, as I believe, the difference in efficiency between U.S. and developing-country firms is typically large, there is much room for quite rapid improvements in the developing countries as they learn how to adopt and adapt already-known techniques from the advanced countries..."*

Arnold Harberger

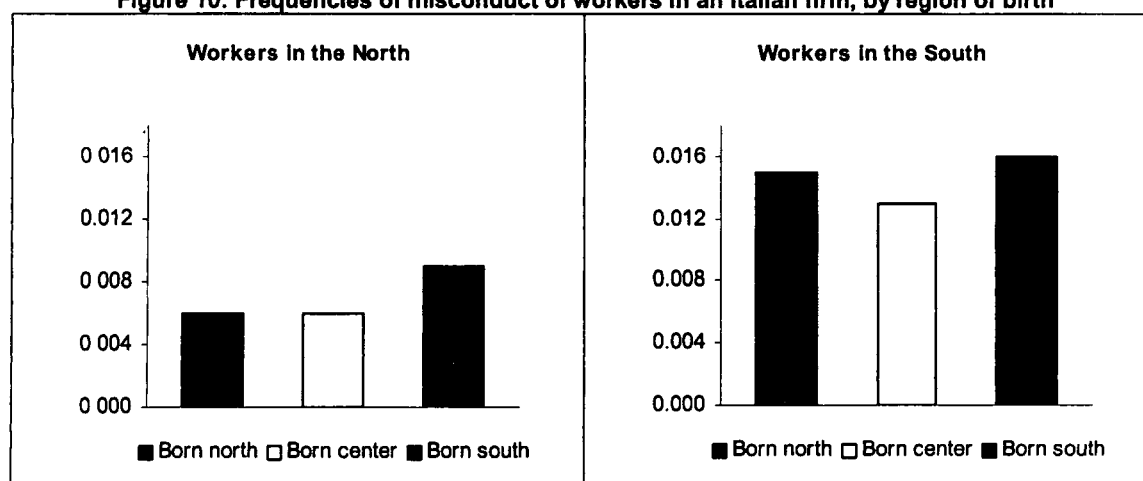
So what does all this imply for poverty reduction?<sup>44</sup> Critical to creating wealth is the capability of institutions that allow people to work together and that create productive jobs in the process. For poverty to be eradicated quickly, these institutions must be open to learning and adapting know-how that already exists—and be capable of applying it efficiently. The traditional factors of production are not too hard to obtain: natural resources, capital goods, finance, ideas, and reasonably competent labor.

<sup>44</sup> Whether we call it poverty reduction or wealth creation or growth, the widespread rise in individual incomes requires productivity improvements and the provision of better products or services. After all standards of living improve when people can get existing products or services at lower cost or better ones at acceptable costs.

But because poor people cannot simply move to areas where capable institutions already exist, pro-poor growth involves diffusing best practices and capabilities to areas where poor people live.

The mechanics of organizing institutions can be learned. For firms, organizational practices can also be “imported,” through foreign direct investment or the movement of firms within countries. The really critical local element of good institutions that is hard to import is the ability of people to work well together—their behavior and their culture. Even firms cannot transplant cultures. A study of a large firm in Italy with operations in both the North and the South shows that worker behavior varies significantly in different parts of the country. When workers from the North move South, they start behaving like those in the South and vice versa (figure 10).

**Figure 10: Frequencies of misconduct of workers in an Italian firm, by region of birth**



Source: Ichino and Ichino (1997).

## V. CORE INSTITUTIONS: MARKETS, FIRMS AND GOVERNMENTS

*“Trying to stop a market is like trying to stop a river.”*

A Vietnamese proverb

*“... a nation’s economic growth and competitive strength rest on more than natural resources, labor and managerial skills, available capital or even the size of internal markets. The wealth of nations during the past hundred years has been based more on the ability of industrial enterprises to adopt and to develop ... technologies and to devise administrative structures to co-ordinate the ... processes of production and distribution.”*

Alfred Chandler

*“...What distinguishes modern government from personal control is its unremitting character. To be governed is to be subjected to the regular pressure of an authority operating to fixed rules...In the full sense of the word, it is arguable that nobody was governed before the later 19<sup>th</sup> century...”*

Jean Dunbabin<sup>45</sup>

**Spontaneous emergence of markets.** Markets are institutions that arise spontaneously even without government intervention. In the most desolate places merchants ply their trade and supply people with goods and services. Lawless places like Somalia today show that trade in almost all goods at world prices is being organized in the absence of government. Even cell phone service with pre-paid cards is available in Somalia as is basic electricity service – for those who can pay. Tiny enterprises and farms operate in all societies.<sup>46</sup>

**The rise of firms and government.** Substantial and sustained wealth creation requires a complex division of labor and more complex organizations than arise spontaneously almost everywhere. The rise of modern firms, operating in markets shaped by modern government, provides the institutional fabric for factors of production to combine more and more productively. To be productive, firms need to play by certain rules and be able and willing to co-operate. They need to respect basic rules such as property rights and contracts so that they have incentives to invest and co-operate with buyers and suppliers. To ensure that products and production processes fit society’s expectations about socially

<sup>45</sup> Quoted in Finer, 1997, p. 70.

<sup>46</sup> McMillan, 2002.



and environmentally sound practices firms need to respect a variety of regulations that condition their property rights. Under such rules, which require the government to establish and enforce them, a symbiosis of small and large firms emerges, which compete, trade and contract with each other. Consider now the key features that characterize effective institutional fabrics combining firms, markets and governments.

#### **A. Experiments and routines—freedom to enter and to fail**

Firms spread best practices and productive jobs to areas where poor people live. But the diffusion is not straightforward. As discussed before, various channels for improving firm-level performance exist that transfer best practice already invented elsewhere. However, not all firms are capable of benefiting from them – even when new firm entry is allowed and when openness to new methods of organization and production exist. There are two fundamental reasons for this. First, all entrepreneurial activity is fraught with uncertainty and thus requires experiments. Second, firms, or any organizations need to create routines to cope with complex tasks. So failure is unavoidable for firms that make the wrong bet or choose unsustainable routines.

**Experiments.** Start with uncertainty. Adopting best practice is not straightforward. Even simple production technologies, such as planting new farm crops, require adaptation to local circumstances. More complex technologies, such as car manufacturing, require extensive learning on the job. It took Korea's Hyundai corporation 14 months of trials to design its first prototype car. It then took experiments with 11 prototypes, 2,888 engine design changes, 97 test engines, and more than 200 test transmissions and 150 test vehicles to produce its first commercial car in 1992.<sup>47</sup>

**Routines.** Now consider routines. The Indian machine tools industry shows that the staff of mediocre firms could do much better than the firms they worked in. Management may not have listened to them, may not have given them a chance, or may have been unable to restructure existing operations. The old companies were stuck in routines that prevented them from improving.

There is no avoiding routines. But there often are different ways of pursuing a productive activity. Even in everyday life we benefit from routines that simplify our tasks. Routines are even more important when it comes to aligning work practices in a firm. They are not bureaucratic aberrations. They are a way of coping with complexity. But they may fail to deliver. They are a consequence of what economists call bounded rationality.

#### **B. Competition—the mechanism to select the most productive firms**

Information problems, uncertainty, and the limited ability to cope with complexity are the root causes of unavoidable failure of firms. So for firms to adopt best practice, there must be mechanisms that deal reasonably well with the failure of firms. Such mechanisms need

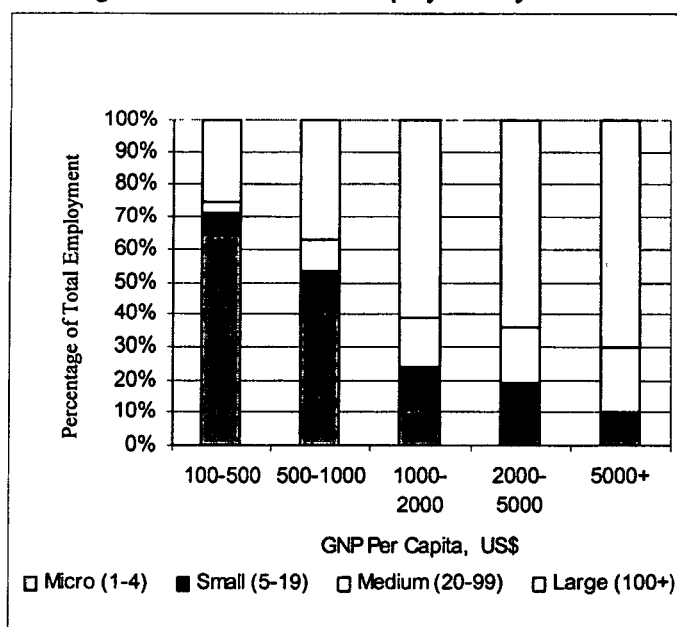
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<sup>47</sup> Kim, 1997.

to allow physical assets, ideas, people, and funds to be used again in new and better ways when a firm fails. This is where the competition in markets comes in. Competitive markets select firms that pursue particular experiments or routines. They also provide incentives for market participants to improve and to adjust when they are facing failure. In some cases, incumbent firms adapt successfully. In others, new entrants drive out non-performing firms.

Over the last twenty years considerable work has been carried out to understand better the way markets with firms work. Most of this work covers advanced countries.<sup>48</sup> However, a significant amount of work has also been carried out in developing countries of all types. The picture is similar in developed as well as developing countries with the main difference that developing economies tend to have smaller firms than advanced economies (figure 11).<sup>49</sup>

Figure 11: Distribution of employment by firm size



Source: Snodgrass and Biggs (1996).

**Heterogeneity among firms.** Traditional economic textbooks treat markets as if all firms are efficient, driven by the incentives from the price signals in markets. When demand increases new firms would enter, and when it decreases some incumbents would fail. In reality the picture is quite different. Typically existing firms are not similarly efficient. Instead, they are quite heterogeneous with substantial dispersion in productivity among firms and among sectors. A detailed review of firm-level performance in 44 different

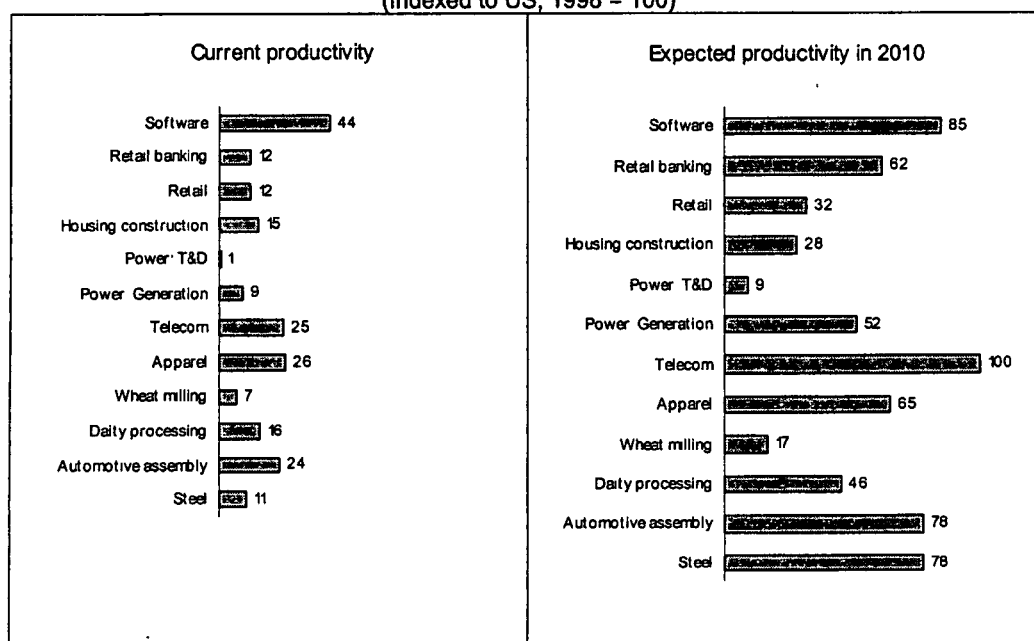
<sup>48</sup> Caves 1998; Sutton, 1997; Tybout, 2000.

<sup>49</sup> Audretsch, 2000; Aw, 2001; Nugent and Yhee, 2001. Also see the World Bank's RPED micro-studies for Africa over the last decade (A list of available studies can be found at <http://www.worldbank.org/afr/findings/french/rped.htm> ).

manufacturing sectors in Mexico shows in each sector that some firms add value while some barely contribute and others destroy value.<sup>50</sup> The average productivity of firms in different sectors in India varies substantially, and remains significantly below best practice (figure 12).

**Competition and the dispersion of productivity.** In general, bringing average practice closer to best practice is of enormous value for wealth creation. Individual firms often have similar opportunities to learn and improve, but fail to do so for the reasons given above. Competition turns out to be the key to bringing average practice closer to best practice. Hence competition is a key part of the diffusion mechanism for best practice. A number of studies support this for countries such as Brazil, India, Korea, Japan, Russia and Thailand.<sup>51</sup>

**Figure 12: India - Current and potential labor productivity**  
(Indexed to US, 1998 = 100)



Note: Figures for expected productivity are derived on the assumption that all productivity barriers are removed. Most of the productivity improvements are expected to come from rationalizing the workforce, improving the organization of functions and tasks and investing in viable assets.

Source: McKinsey Global Institute (2001).

**Entry and exit patterns.** The key element in competition is the freedom to enter the market and to fail. Free entry means that exit from markets must be possible for substandard enterprises. Where inefficient but politically well-connected firms are sustained through protection or subsidies by governments or through bail-outs by

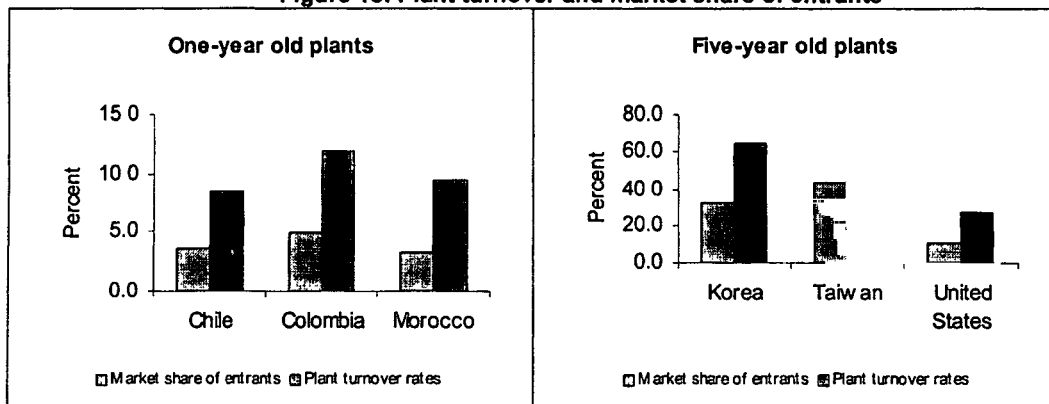
<sup>50</sup> Harberger, 1998.

<sup>51</sup> Driemeier, 2001; McKinsey Global Institute, various years.

financial institution, new firms can compete only with difficulty. They have difficulty obtaining credit, and they tend not to enter.

When entry is possible, new firms do not enter only when demand is up, and old firms do not leave only when demand declines. Every year around 5 to 20 percent of all firms enter the market and a similar number of older firms go out of business. Most new firms are small, and some 40-60 percent go out of business within five years after entering. Data from developing countries suggest that the average new entrant is a little more productive than firms exiting the market. In most economies, the turnover of firms helps increase productivity. In part this reflects people being successful who have previously failed. In part it reflects new entrants altogether.

**Figure 13: Plant turnover and market share of entrants**



Note: The plant turnover rate is the average of the entry rate and the exit rate of plants.  
Source: Tybout (2000).

**Opportunity for small businesses and farms.** Many of the key measures to help small farms and micro-enterprises are not fundamentally different from those affecting other firms. Hernando de Soto has demonstrated in writing and in his experiments with setting up new small firms that burdensome entry regulations, red tape, bureaucratic harassment, and the absence of clear property rights and contract security make it impossible for many small entrepreneurs to establish themselves, to become formal, and to grow. That spotlights the importance of programs to reduce entry regulations, reduce bureaucratic harassment, and clarify and formalize property rights (box 3).

### **Box 3: Property rights and poverty reduction**

According to Hernando de Soto (2000), the total value of the fixed property held but not legally owned by the poor in developing countries is around \$9.3 trillion. This is 93 times the amount of official development assistance to developing countries over the past 30 years and 20 times the stock of foreign direct investment in developing countries between 1989 and 1999. But, because the ownership of these assets is not formalized, the people in poor countries cannot use them as collateral to raise cash.

Field research has shown that the reason why businesses stay informal and landowners do not register their property is not so much because they have to pay taxes but because they are usually hindered by the bureaucracy. For example, de Soto and a team of his researchers tried to register a one-man clothing workshop that they had set up outside Lima, Peru. It took 289 days, involving many hours of filling forms, traveling by bus into central Lima, and queuing up to see the relevant officials, to register their micro-enterprise. The whole operation cost \$1,231 – 31 times the monthly minimum wage in Peru.

In Malawi, houses are built on “customary” land, i.e. land that the residents have no formal title to but that has been cultivated by their family for generations. The village chief usually oversees any disputes about boundaries. If a family breaks the rules of the tribe or leaves the property unattended, the chief has the power to take the land away and give it to someone else. The contract may be oral, or it may be written and signed by the chief. The problem is that no bank will accept it as a collateral. The land and the property built on it turns out to be what Hernando de Soto calls “dead” capital.

All rich industrialized countries have clear, enforceable and almost inclusive property rights. Although better property laws are not the only reason why some countries are better off than others, de Soto insists that they make a significant difference.

Source: De Soto (2000).

**Internal growth.** Productivity growth comes not only from entry and exit, but also from the growth of existing firms responding to market incentives. Some of the new entrants turn out to be successful and the best become large firms.<sup>52</sup> Productivity growth also comes from large firms branching out and entering new markets, sometimes through mergers and acquisitions of promising firms. As good firms become large they tend on average to have higher productivity than small firms. But the highest growth rates are found among small companies that happen to be particularly efficient. Firms are productive not because they have a particular size but because they are good.<sup>53</sup>

In a new industry, small firms play the prime role in innovation and productivity development (box 4). The good firms continue to improve through internal growth, taking over less well-managed companies or buying up promising small firms that need capital.<sup>54</sup> Once firms have proven themselves and become large, they remain more productive and last much longer than the average smaller firm. Indeed, many large firms are like collections of small ones. They operate an internal market for corporate control, which can be superior to that of the broader market. And they owe their success to their ability to allocate people, capital, ideas, and assets better than firms operating at arms-length from each other.<sup>55</sup> But, there is no guarantee, and large firms may also fail eventually.

<sup>52</sup> Rajan and Zingales, 1998.

<sup>53</sup> Aw, 2001.

<sup>54</sup> Ravenscraft and Scherer, 1987.

<sup>55</sup> Hellwig, 2000; Klein, 2000.

**Box 4: Markets, innovation and the state**

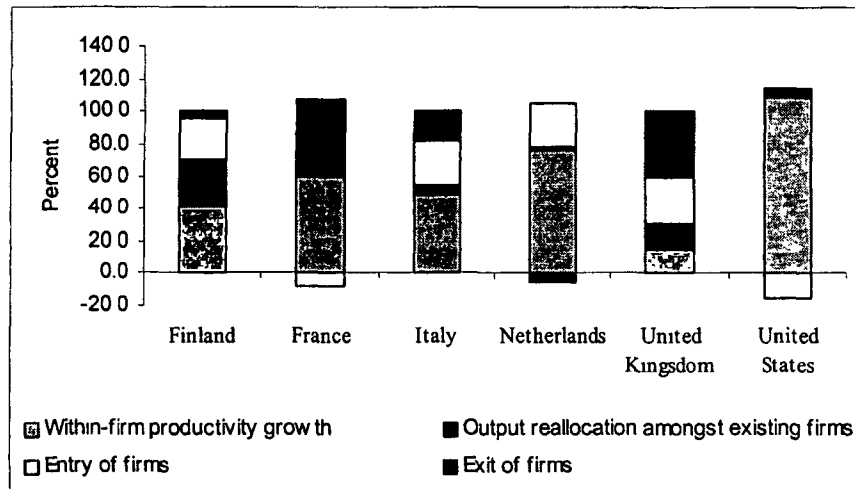
In the 1920s and 30s, around 100,000 different varieties of airplane were flown. All over the world, enthusiastic inventors were selling airplanes to intrepid pilots and to fledging airlines. Many of the pilots crashed, and many of the airlines became bankrupt. Of 100,000 types of airplane, about 100 survived to form the basis of modern aviation. The evolution of airplane was a strictly Darwinian process in which almost all the varieties of airplane failed, just as almost all species became extinct. Because of the rigorous selection, the few surviving airplanes are reliable, economical, and safe.

Source: Dyson (1998).

**The symbiosis of large and small firms.** All sectors in all market economies have a mix of many small, fewer medium-size, and a few large companies. The average size varies with economies of scale between sectors, but within sectors there are firms of many different sizes – not like in the textbooks that suggest all firms in an industry should look similar, reflecting relevant economies of scale. Small, medium, and large firms do not just exist next to each other in markets. They also interact through buyer-seller relationships, through various co-operative arrangements, through credit relations. Many times intricate networks of firms exist, within large companies, between large and smaller ones and in clusters of various types.

The way that a firm enters, grows, and exits varies from country to country, an area little studied so far. A recent OECD study shows that the average new entrant in the United States is less efficient than existing firms. But entry is valuable because it allows new ideas to be tried out and the companies that turn out to be good can easily grow to become larger. Most productivity growth in the United States is thus due to the internal growth of firms and not to the entry of more efficient firms. But in several European countries, the entry of better firms accounts for a large part of productivity growth, and internal growth appears less effective. This may reflect barriers to growth in those countries, such as labor regulations for firms above small sizes (figure 14). In developing countries very small informal enterprises proliferate, preferring to remain informal because of the burden of regulations and taxes on formal firms.

**Figure 14: Decomposition of multifactor productivity growth  
in manufacturing**  
(contribution of each component to total annual productivity growth)



Source: Scarpetta et al. (2002).

In this ecology of firms, markets leave ample room for new organizational species to emerge, spanning atomistic small firms, large hierarchical firms, internal firm markets for corporate control, and all sorts of co-operative arrangements among firms. Customer demand provides the main feedback mechanism, as the firms survive that meet customer demand most effectively. The diffusion of best practice is accomplished in this well-functioning ecology, not by any single measure or any single type of firm. Governments shape the ecology and the niches allowed by the way they set property rights, regulations, taxes and other relevant parameters.

## VI. Market failure and the politics of change

When it comes to generating growth or establishing “competitiveness”, special government support beyond allowing the ecology of firms to work is often justified with reference to market failures that may plague learning processes and access to finance. Learning needs time, hence it is argued that certain sectors that have potential for growth might need temporary protection of some type until they are ready to face the gale of full international competition. Learning also is to a degree embodied in individuals. When firms spend resources to train individuals the latter may decide to leave and reap the benefits for themselves. Hence firms might be overly reluctant to invest in training.<sup>56</sup> When it comes to access to finance, financial institutions may not be willing to lend to small and medium enterprises, because they have little track record, are likely to go bankrupt within a few years and are typically dependent on a single owner or just a few persons, who might be affected by illness or other sudden changes in life.

**Large firms as institutions to cope with market failure.** Special institutional innovations are needed to cope with such market failures. The larger firm itself is precisely such an institution. It is in fact, the first line of defense against market failure. It is capable of building a track record vis-à-vis financial institutions. It is less dependent on individuals than smaller firms. It can invest in small subsidiaries while they learn and it is more likely to retain staff and benefit from investment in training.

**Collateral and credit information systems.** As a second line of defense, governments can help with access to credit by establishing functioning property rights systems that allow collateral systems to function so that individuals and small firms can get access to credit.<sup>57</sup> In fact, everywhere in the world most of small enterprise finance is secured through collateral, for example through mortgages on the owner’s real estate. Credit information systems that help track the payment record of individuals and small firms are another key mechanism to help small market participants to establish their credit, and hence access to finance.

**Support programs for small and medium enterprises and farmers.** Beyond these basic measures, on which there is relatively widespread consensus, governments can establish further programs to support particularly small and medium-sized firms. Directed and subsidized credit programs for small urban and rural enterprises and farms exist in most countries. Advisory services for farms and small firms, for example on new crops or farming techniques or on business management are also widespread. However, the most complete review of studies on the experience with such schemes worldwide suggests that very few schemes have been seriously evaluated.<sup>58</sup> Overall, many remain

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<sup>56</sup> Smaller firms can in particular overcome the problem of incentives to train as long as they are able to employ apprentices at very low wages as happens in a number of countries. Many people may then choose to learn at low wages in small firms in the expectation of higher income later rather than taking on an initially better paid job with the state, which, however, tends to yield a lower lifetime income. However, where labor regulations prohibit low wages for apprentices, small firms may not have the right incentives to invest in training.

<sup>57</sup> Fleisig, 1995.

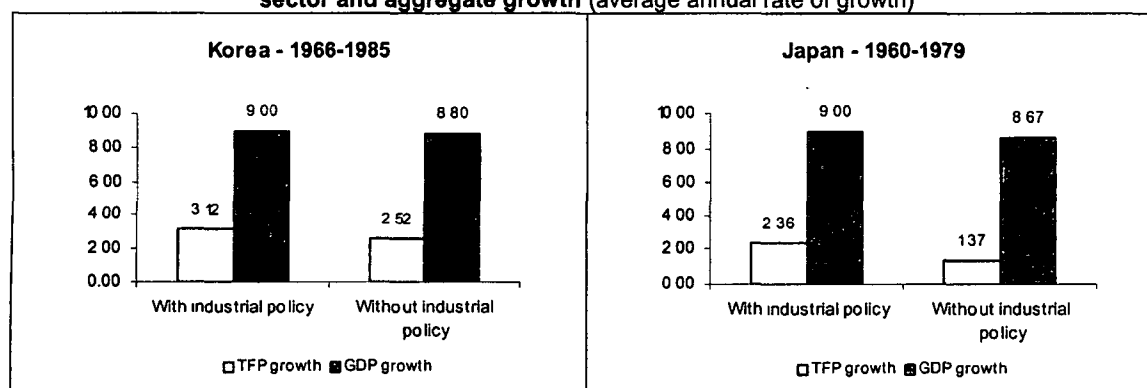
<sup>58</sup> Batra and Mahmood, 2001.



ineffective or are abused, in particular subsidized schemes. The key hypothesis that emerges from existing experience is that the schemes with the greatest chance of working well are those aligned with basic market principles. Decent credit support programs tend to avoid subsidized credit terms. Sound approaches to advisory services tend to emphasize creation of demand for such services and delivery via market mechanisms. In addition, special support schemes seem to require a sound basic overall policy framework for markets where they operate.

**Industrial policy.** Special government support for domestic firms of all types has typically been discussed under the heading of “infant industry” protection or “industrial policy”, even though other sectors might be affected as well, such as services or agriculture. Essentially industrial policy consists of a mix of policies that create room for domestic firms to learn and to obtain finance so as to improve productivity. In a great number of countries such policies have been a disappointment. The above-cited case of the Indian machine tool industry provides an example, where a protected industry has not used protection to learn but to be satisfied with substandard performance. However, particularly in East Asian economies like Japan and Korea industrial policy is often seen to have helped. A recent study examined productivity performance in Japan and Korea sector by sector (figure 15). It turns out that the sectors that benefited from special support contributed only a modest amount to productivity growth. Overall, even in the two arguably most successful cases industrial policy has at best been a small factor for success.

**Figure 15: The effect of industrial policy on growth of total factor productivity in the manufacturing sector and aggregate growth (average annual rate of growth)**



Note: This analysis is based on the assumption that the growth in manufacturing sector accounted for only a third of the growth in GDP in both Korea and Japan. The TFP growth figures relate to the manufacturing sector only and not to the whole economy. Source: Pack (2000).

Clearly, to be successful industrial policy needs to expose the firms that are supported to some form of serious competition, for example, by tying continued support to export success in truly competitive markets as in the case of Korea and Japan.<sup>59</sup> Openness to

<sup>59</sup> Stiglitz, 1998b.

best practice and exposure of firms to the selection mechanism of competition is critical for government intervention to help. Even analysts who question economic orthodoxy and are open to “heterodox” approaches conclude that “we do not want to leave the impression that we think trade protection is good for economic growth. We know of no credible evidence – at least for the post-1945 period – that suggests that trade restrictions are systematically associated with higher growth rates.”<sup>60</sup>

**The politics of support schemes.** Whatever form of government intervention in support of access to finance or learning one may consider for small and large firms, in urban or rural areas, basic market forces appear needed to give these policies a chance to succeed. It may also be that the interventions “work” in places where otherwise sound institutions and policies are in place anyway.<sup>61</sup> Note that among successful special schemes such as export promotion, industrial policy, and the like, the same small group of countries is mentioned again and again – particularly Japan, Korea and Singapore.<sup>62</sup>

Doubts about their effectiveness have not reduced the attraction of various forms of government support schemes, for example those for small and medium sized firms, which are popular all over the world. Other subsidy schemes are widespread as well and the evidence about their effectiveness is neither stronger nor weaker. However, they meet with a bit more skepticism such as special fiscal incentives for foreign direct investment or some agricultural support schemes in major OECD economies. This suggests that it may well be that the drivers for support schemes have in fact little to do with economic considerations per se. They may mostly be part of the political give-and-take of any nation. In particular, the spread of best practices and more productive job upsets old patterns of production, typically disrupts the lives of some people all the while it improves those of others and in the end is the way to raise living standards broadly. The support schemes may thus help good policy because they may moderate the pain of adjustment and help build political backing for it. However, they may also help entrench vested interests and the survival of inefficient firms and thus hold back productivity growth.

**Insurance schemes.** A major issue for policy-making is thus how to deal with demands for special support schemes. On the one hand political acceptability may require such schemes. On the other hand they must be designed not to undermine the workings of sound markets and the development of world-class capability in firms. While the politics of each country probably require somewhat different approaches, there may be one general principle to consider. As has been discussed above, the creation of successful ventures or firms requires taking risks. Experimentation is needed and failure is unavoidable. People are more likely to take risks when they know that there is some safety net to fall back on in case of failure. A sensible social safety net is thus good for efficiency and growth, not just for equity and fairness. For example, the institution of limited liability, which limits the losses of business owners, has helped promote

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<sup>60</sup> Rodriguez and Rodrik, 2000.

<sup>61</sup> Same as aid effectiveness.

<sup>62</sup> Keesing and Singer, 1990; Rhee et al., 1984; Thomas and Nash, 1991.

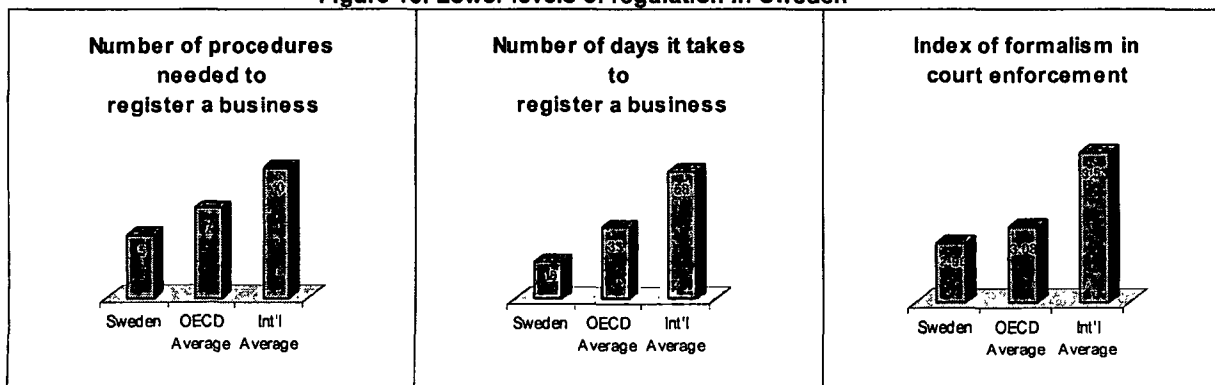
entrepreneurship. Small farmers are more likely to invest in risky ventures when they have a way of insuring themselves.

Political acceptability and economic efficiency may thus best be helped by designing forms of insurance appropriate for a particular economy. For example, large-scale unemployment insurance can be afforded by advanced economies. Smaller insurance schemes are practical in poor countries. This would include micro-finance programs, which are mostly not used to fund investment but to help deal with temporary inability to pay for consumption and which spread default risk among small groups of people.<sup>63</sup>

**The New Swedish Model.** The general picture that thus emerges for desirable government policy might be termed the “New Swedish Model”. Before the 1990s, Swedish economic policy was often looked at as a “third way” between capitalism and socialism. After the economic crisis of the early 1990s Sweden and several other Scandinavian countries have remodeled themselves. The cornerstones of the current model are:

- prudent macro-economic policies and low inflation;<sup>64</sup>
- a highly competitive environment for firms with few barriers to entry and growth and minimum red tape (figure 16); and
- a strong social safety net.

Figure 16: Lower levels of regulation in Sweden



Note: The index of formalism measures substantive and procedural statutory intervention in judicial cases at lower level civil trial courts.

Source: Doing Business Database

As countries advance, the complexity and average size of institutions, be they firms or government agencies or other forms of organizations, increases. The share of government in total economic activity also increases, not because government interferes with production decisions and the ecology of firms, but because of the growth of transfer payments that lie behind the social safety net of advanced societies, which in turn

<sup>63</sup> Morduch, 1999.

<sup>64</sup> Dollar and Kraay, 2000.

supports risk-taking in the productive sectors. The “New Swedish Model”, whether we call it “capitalism with a heart” or “socialism with a head” appears to be the main avenue ahead.

**Partial and heterodox reform.** The question remains how good governance in society at large arises and what can be done to promote it. A critical point is that we do not know how to engineer good governance. It is perfectly possible and plausible that pure chance and luck play a large role in the creation of successful societies.<sup>65</sup> It is equally clear that highly incomplete reforms have to be sufficient for growth to take off. Otherwise no country could ever have developed. For example, countries like Bangladesh or China have seen progress, admittedly of varying degrees, by pursuing only partial reforms and despite continuing and pervasive governance issues. It is also clear that many successful countries have pursued policy mixes that appear “heterodox”, like Japan, Korea, China or Vietnam. Others have successfully pursued relatively “orthodox” policies like Chile and El Salvador, again with success of varying degrees. But partial reform and heterodox policy may equally be associated with arrested development as in the case of countries that unsuccessfully pursued import substitution. Likewise a heavy dose of orthodoxy has not by itself helped some countries, for example in Latin America, to grow rapidly.

**Creative destruction.** Also successful development may require destruction of vested interests, i.e. some form of revolution.<sup>66</sup> It can thus be quite disruptive for some time with unavoidable winners and losers. Arguably Germany, Japan, Korea and Taiwan all benefited to some degree from the disruption of war and from policies in part imposed by the United States after World War II. It remains unclear how much disruption is unavoidable and how much disruption is excessive.

**Competition among jurisdictions.** Given the uncertainty about the exact mix of reforms and institutional change that makes for successful development, it must surely be valuable to allow experimentation with different mixes of institutional and governance reform. The reason we have advanced economies today is the industrial revolution that came out of Europe. Competition among squabbling European states and principalities led to the world’s growth miracle, the “European Miracle” as historian Edwin Jones called it.<sup>67</sup> China, the previously more advanced nation was left behind, however, as central control and the domination of mandarins over merchants arrested development.

So for the development of good governance a selection mechanism is also important, namely competition among nations, or more generally among various types of jurisdictions – across states or within, for example, federal systems. Both for the firm and the government, a symbiosis of competition and rule-based co-operation seems required for complex societies to emerge and to allow their citizens to prosper.

To sum up, effective wealth creation requires capable institutions. A complex symbiosis of competition and co-operation on the basis of accepted rules characterizes successful

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<sup>65</sup> Easterly, 2001.

<sup>66</sup> Olson, 2000.

<sup>67</sup> Jones, 1987.

societies. Some basic measures to establish such societies are known, for example respect for property rights and contracts as well as freedom for firms of all types to enter markets as well as freedom to fail. Just as we cannot predict exactly which type of firm will succeed so we cannot predict which type of government policy and institutional mix will be most successful. Competition among jurisdictions is as important to institutional development as that among firms. We have learned some basics on how to facilitate development, but we do not know how to engineer it and have to remain open to experiments. Hopefully we can improve the chances of success of unavoidable experiments by studying in more detail the way markets, firms and governments interact.<sup>68</sup>

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<sup>68</sup> World Bank, 2001b.

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